Economic Trends

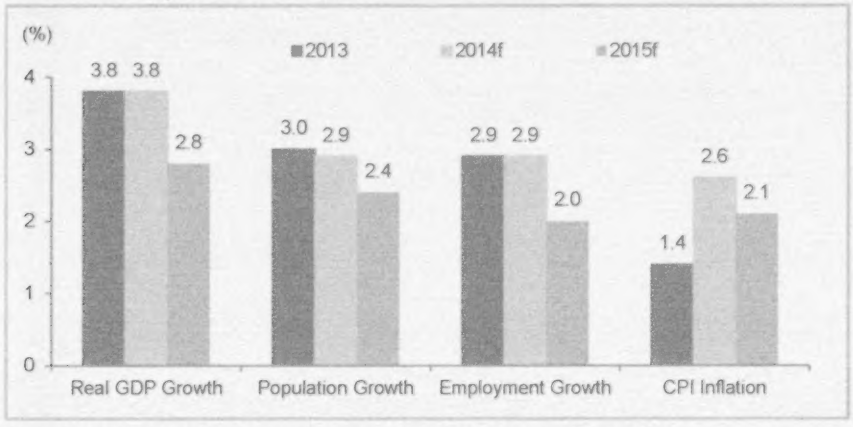
Solid growth expected despite oil price decline

This edition of Trends is taken from the *Second Quarter Fiscal Update and Economic Statement*, released on November 26, 2014. The InFocus shows that resource price volatility has a much larger impact on incomes and government revenue than on the real economy in Alberta.

The Alberta economy continues to grow at a persistently high rate. Real GDP is forecast to expand by 3.8% in 2014, the fifth straight year above its historic trend of 3%, supported by exports and an expanding household sector. This forecast remains unchanged from the *First Quarter Update*, but up slightly from *Budget 2014*. Alberta's robust expansion has come at a time of weakness in the global economy, when growth has been slow and uneven. Slumping demand has kept global inflationary pressures low, while dimmer prospects elsewhere have encouraged record numbers of people to migrate to Alberta. These factors have prevented the economy from overheating.

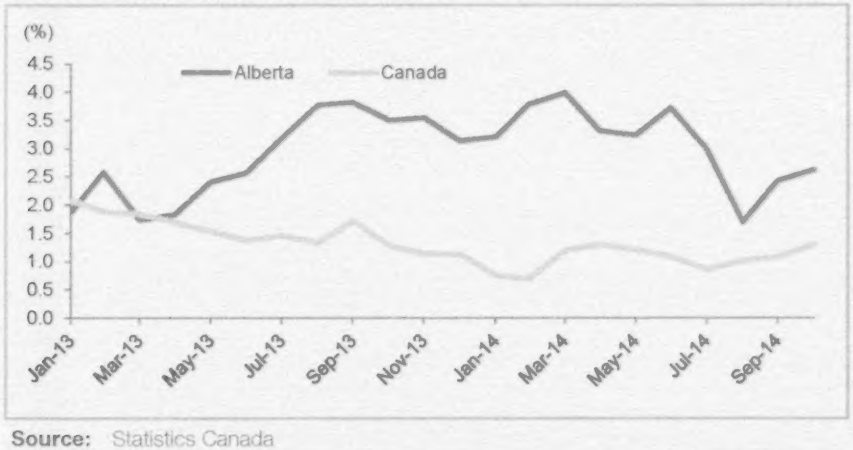
Recent developments in global energy markets, however, are expected to reduce the momentum of Alberta's economy heading into 2015. World oil prices have dipped since the *First Quarter*, reaching the lowest level since 2012. Lower oil prices will weigh on the value of Alberta's exports and nominal GDP, while reducing corporate profits and government revenue. The effects of lower world oil prices have been partly cushioned by a weaker Canadian dollar and narrower light-heavy oil price differential. As in the past, the magnitude of lower oil prices on Alberta's real economy is expected to be much less pronounced than on revenues (see pg. 3-4). Real GDP growth in 2015 is forecast to be a strong, but more moderate 2.8%, down from 3.0% at *Budget 2014* (Chart 1).

Chart 1: GDP growth moderating in 2015
Forecast for Key Alberta Indicators



Sources: Statistics Canada and Alberta Treasury Board and Finance

Chart 2: Alberta labour market softening
Alberta Employment Growth (year-over-year)



Source: Statistics Canada

Alberta Household Sector

Labour market moderating

Alberta continues to lead the provinces in job growth, although employment gains have eased in recent months (Chart 2). Employment is forecast to grow by 2.9% in 2014, unchanged from the *First Quarter*, but up from 2.6% at *Budget 2014*. Heading into 2015, employment growth is expected to be a more moderate 2.0%, down slightly from *Budget 2014*. Wage growth, which has been exceptional this year, is also expected to ease in 2015, but continue to far outpace inflation.

Solid population gains

Favourable labour market conditions are attracting people to the province, but not quite at the blistering pace set over the last few years. Alberta's population growth for the 2014 census year came in at 2.9%, slightly lower than forecast in the *First Quarter*. Growth in 2013 was revised down to 3.0% as part of Statistics Canada's annual revisions.

These factors, combined with the expectation that interprovincial migration will ease in the coming months, put the forecast of Alberta's 2015 population growth at a strong 2.4%. This is down from the *First Quarter*, but in line with *Budget 2014*.

Housing market fuels growth

Robust wage growth, along with gains in employment and population, have propelled Alberta's housing market. Housing starts have seen double-digit gains, led by growth in multi-unit construction. Starts have been adjusted up from *Budget 2014* to 39,300 in 2014 and 36,900 in 2015 to reflect continued strength in the housing market.

Consumers to keep spending

Retail sales are up a solid 8.5% year-to-date, well ahead of the pace expected at *Budget 2014*. Bolstered by higher anticipated primary household income in 2014, consumer spending will make a strong contribution to growth this year and remain robust in 2015. Consumer price growth has held steady at just over 2.5%. Inflationary pressures are expected to ease on lower energy prices, and consumer prices are forecast to grow by 2.1% in 2015.

Alberta Business Sector

Oil prices drop

World oil prices have fallen over 25% since June. Supply growth, particularly from US tight oil plays, is outstripping weak global demand. Ongoing geopolitical tensions in the Middle East, North Africa, and Ukraine have not been able to offset the price slide. As a result, the forecast for WTI is now US$88.88/bbl in 2014-15, down $8 from the *First Quarter*. In contrast, the price for Alberta's heavy oil benchmark WCS has been supported by strong heavy oil refinery demand, pipeline expansions, and the increasing use of crude-by-rail. These factors have led to a narrower WTI-WCS differential forecast, from US$25/bbl at *Budget 2014* to around US$18/bbl for 2014-15.

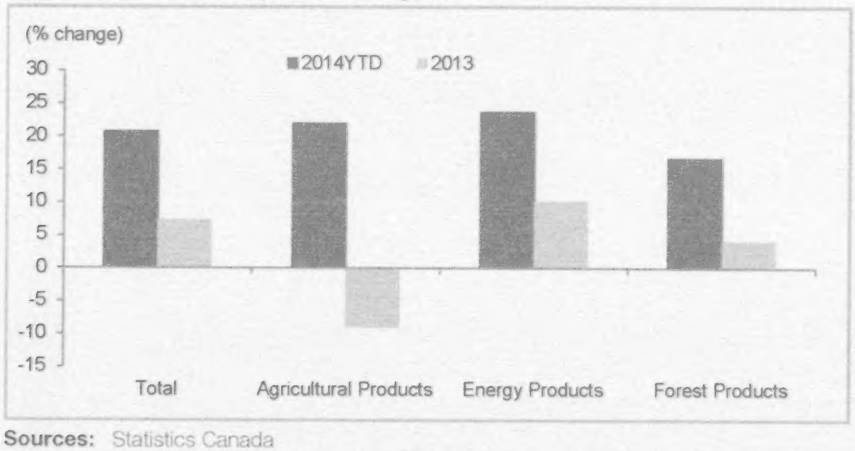
Canadian dollar weakens

The Canadian dollar has drifted downward since *First Quarter*. This is due to a strengthening US dollar, expectations that interest rate increases in Canada will lag the US, and a general weakness in commodity prices. The exchange rate forecast for 2014-15 has been lowered to 90.5 US¢/Cdn$. A weaker dollar bolsters exports and resource revenue.

Business activity stays strong

Exports and manufacturing shipments have posted exceptional growth year-to-date, led by energy products, but also due to broad-based gains across several product categories (Chart 3). This has resulted in an upward revision to corporate profits (net operating surplus) for 2014. Exports will continue to be supported by higher crude production and growth in agriculture, food, and forestry products. However, lower oil prices are expected to pull down export values and net corporate operating surplus next year.

Chart 3: Alberta exports seeing broad-based growth
Alberta Export Growth by Select Categories



Sources: Statistics Canada

Construction leads investment

Non-residential construction in the province is on track for another solid year. Spending on non-residential buildings is up an impressive 8.0% through three quarters, led by the commercial sector. Building permits point to more gains in commercial investment, with intentions strong for Edmonton and Calgary. In the energy sector, lower oil prices are expected to weigh on conventional oil investment. Conventional producers react more quickly to changes in cash flow than oil sands producers, who have committed capital and longer investment horizons. Oil and gas investment is expected to be a slight drag on growth in 2015.

External Risks

Global economic conditions are slowly improving, but with mixed results. Given Alberta's high reliance on trade and commodities, the outlook is subject to a number of risks:

- There is downside risk for Alberta's economy if oil prices remain lower for a prolonged period, affecting employment, business investment, and housing.
- Escalating geopolitical events, such as tensions in Ukraine or Iraq, could dampen global economic growth and increase financial market volatility.
- Lower interprovincial migration could lower housing demand and consumer spending.
- On the upside, a sudden improvement in oil prices, for example due to OPEC supply cuts, could lift economic activity while putting upward pressure on costs.

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inFocus

Strength amid resource price volatility

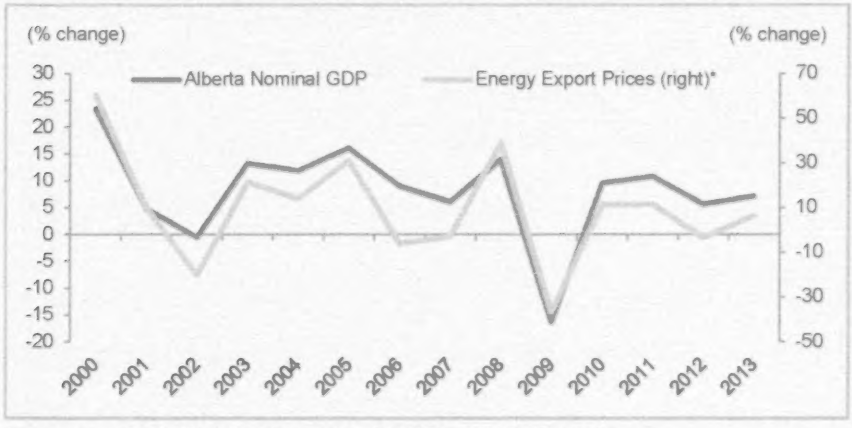
Alberta's resource-based economy remains exposed to a high degree of price volatility, resulting in large fluctuations in incomes and government revenue. The economy, however, has demonstrated resiliency to transitory price changes over the past three decades.

Income volatility

Revenue highly sensitive to price swings

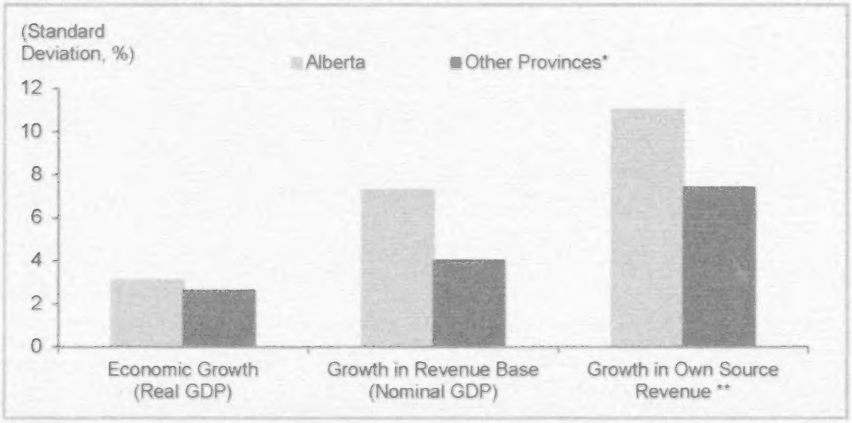
Natural resources have long been the primary driver of Alberta's economy. The share of provincial gross domestic product (GDP) directly derived from agriculture, forestry and oil and gas has averaged 27% over the last three decades, and 25% in 2013. The energy sector has been the principal driver, accounting for the bulk of business investment and exports.

Chart 1: Revenue sensitive to energy price swings
Alberta Nominal GDP and Energy Prices



Sources: Alberta Paashce (current weight) index, TBF Calculation

Chart 2: Real economic growth more stable
Volatility of Various Measures, 1983-2013



Source: Statistics Canada, Finance Canada, Treasury Board and Finance calculations
* Unweighted average of provincial standard deviations
** Based on fiscal years between 1987-88 to 2013-14

Alberta's reliance on resources has subjected the province to a high degree of price volatility. Prices influence the value of goods and services produced, which in turn determines provincial income, or nominal GDP. Chart 1 shows the tight relationship between growth in energy prices and nominal GDP. Similar levels of volatility are seen in other resource-based provinces, including Saskatchewan and Newfoundland and Labrador.

Not surprisingly, the provinces with the most volatile income also have the most volatile government revenues. Volatility in Alberta own source revenue (government revenue excluding federal transfers) consistently ranks among the highest in Canada, along with Newfoundland and Labrador and Saskatchewan (Chart 2). Alberta's high revenue volatility is driven almost entirely by non-renewable resource revenues, which made up around 20% of total government revenue in 2013-14. For the other major revenue sources, such as personal income tax, Alberta's volatility is comparable to other provinces (Landon and Smith, 2010)1.

Economic performance

Real economic growth more stable

In Alberta, there is an especially large gap between the volatility of economic growth and the volatility of income and revenues. Alberta's real GDP growth has been only slightly more variable than the other provinces since 1982, while a much larger volatility gap is observed for nominal GDP and own source revenue (Chart 2).

1 *Landon, S and C. Smith (2010). Energy Prices and Alberta Government Revenue Volatility. CD Howe Commentary No 315.*

Weathering volatility

Despite ongoing price swings, Alberta has, for a long period, sustained its position as Canada's most prosperous province. Per capita GDP, a broad measure of living standards, has ranked top among the provinces over the last 30 years (Chart 3).

Along with a long-term upward trend in resource prices, strong economic growth has underpinned Alberta's rising living standards. Alberta has outperformed all provinces in real GDP growth since the 2009 recession, ranking among the highest growth jurisdictions in North America. In the 1990s, the province led all provinces in economic growth, and in the 2000s lagged only Newfoundland and Labrador. High growth has been made possible by large inflows of capital, particularly in the energy sector, but also in a range of manufacturing and service industries.

Alberta's long-standing economic strength has come despite a series of challenges in recent years. In 2008, at the depth of the financial crisis, world oil prices collapsed to just under $US40/bbl. In 2009, as investment pulled back, Alberta's economy shrank by 4.1%, only to recover all the lost output the following year. In 2012, WTI oil prices dipped below $US80/bbl and the differential widened amid severe pipeline constraints. That year, the economy expanded by 4.5%. Alberta's other resource sectors, agriculture and forestry, have also experienced large swings in market conditions.

Not all changes have been transitory. In the natural gas industry, new drilling technologies have flooded North America with gas in recent years. This transformation pulled down prices and sharply lowered production. Alberta's energy sector responded by shifting to oil production, particularly in the oil sands, which has more than offset the downturn in gas.

Growth without overheating

A critical challenge for Alberta's fast-growing economy is to maintain growth without hitting major capacity constraints. In the past, Alberta's expansion has been hampered by periods of overheating, often caused by labour shortages and characterized by rapid cost escalation, as during the 2004 to 2008 boom.

In the latest expansion, growth since 2010 has actually outpaced the last boom, but without the usual cost pressures and generalized labour market shortages that typically accompanies such high growth. This more sustained expansion has in large part been made possible by record migration, which has helped fill job vacancies in the province (see First Quarter feature).

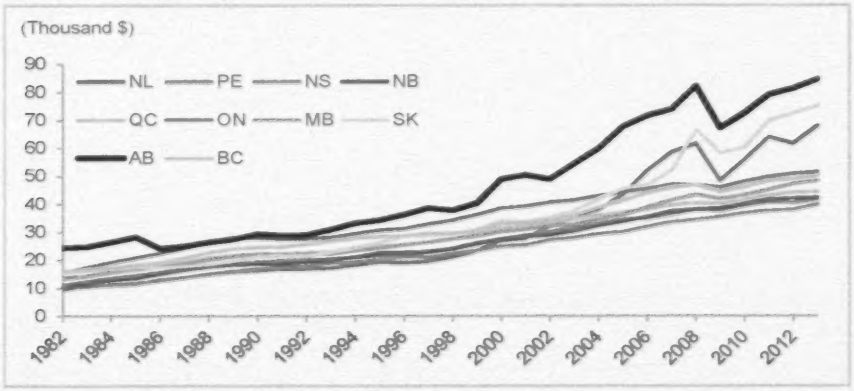
Migration will remain critical to Alberta's economic growth. Using its macroeconomic model, Treasury Board and Finance (TBF) estimates that a reduction in net migration of about 15,000 per year from its expected average pace of 55,000 would shave an average of 0.3 percentage points off GDP growth per year between 2015 and 2020, while raising wage and cost pressures.

Implications

The recent drop in oil prices highlights Alberta's high exposure to global risks. As before, the pullback will weigh on government revenues and subtract from corporate profits and household incomes; however, as demonstrated by Alberta's past economic resiliency, the impact of lower oil prices on the real economy is expected to be much more muted.

The Alberta economy has a great deal of momentum. A key driver is the oil sands, where projects are based on long term price expectations and most have already committed large amounts of capital. These projects are increasingly shifting to the production phase, which will fuel Alberta's exports. Continued growth is also expected in Alberta's manufacturing and service industries. Though weaker prices will take some heat out of the economy next year, real GDP growth is forecast to remain strong, at just under 3%.

Chart 3: Alberta has ranked among the top provinces in GDP per capita
Nominal GDP per Capita



Source: Statistics Canada